



# STATE BOARD OF EQUALIZATION STAFF LEGISLATIVE BILL ANALYSIS

# DRAFT

Date Amended:	05/17/11	Bill No:	<a href="#">Senate Bill 686</a>
Tax Program:	Sales and Use Tax	Author:	Padilla
Sponsor:	Author	Code Sections:	RTC 6377.1
Related Bills:	SB 47 (Alquist) SB 395 (Dutton) AB 204 (Halderman) AB 218 (Wieckowski) AB 303 (Knight) AB 979 (Silva) AB 1057 (Olsen)	Effective Date:	Upon enactment, but operative 01/01/12

## BILL SUMMARY

This bill would provide a sales and use tax exemption for purchases of qualifying tangible personal property by persons engaged in biotechnology manufacturing and research and development activities, as specified and defined.

### Summary of Amendments

Since the previous analysis, this bill was amended to (1) clarify that a qualified person does not include a person engaged in specified research and development and marketing research activities, (2) add a sunset date, and (3) require the Legislative Analyst's Office (LAO) to report to the Legislature on the effectiveness of this tax exemption.

## ANALYSIS

### CURRENT LAW

Under current law, business entities engaged in manufacturing and research and development activities that make purchases of equipment and supplies for use in the conduct of their manufacturing and related activities are required to pay tax on their purchases to the same extent as any other person either engaged in business in California or not so engaged. Current law does not provide special tax treatment for purchases of equipment used by these entities in their biotechnology manufacturing and research and development activities.

Beginning July 1, 2011, the statewide sales and use tax rate (7.25%) imposed on taxable sales and purchases of tangible personal property is made up of the following components (additional transactions and use taxes (also known as district taxes) are levied by various local jurisdictions and are not reflected in this chart):

Rate	Jurisdiction	Purpose/Authority
5.00%	State (General Fund)	State general purposes (Revenue and Taxation Code (RTC) Sections 6051, 6051.3, 6201, and 6201.3)
0.25%	State (Fiscal Recovery Fund)	Repayment of the Economic Recovery Bonds (RTC Sections 6051.5 and 6201.5, operative 7/1/04)

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Rate	Jurisdiction	Purpose/Authority
0.50%	State (Local Revenue Fund)	Local governments to fund health and welfare programs (RTC Sections 6051.2 and 6201.2)
0.50%	State (Local Public Safety Fund)	Local governments to fund public safety services (Section 35, Article XIII, State Constitution)
1.00%	Local (City/County) 0.75% City and County 0.25% County	City and county general operations (RTC Section 7203.1, operative 7/1/04); Dedicated to county transportation purposes
7.25%	Total Statewide Rate	

The 1% General Fund tax under Sections 6051.7 and 6201.7 will expire on 6/30/11.

#### PROPOSED LAW

This bill would add RTC Section 6377.1 to the Sales and Use Tax Law to provide a full sales and use tax exemption (7.25%, plus any applicable district taxes) for the following purchases made by a “qualified person” for use in “biotechnology manufacturing”:

- Qualified tangible personal property to be used 50 percent or more in any stage of manufacturing of property (i.e., machinery, equipment, component parts, belts, shafts, computers, software, and pollution control equipment), as specified.

The bill would define a “qualified person” as any person engaged in “biotechnology manufacturing.” The bill defines “biotechnology manufacturing” to mean manufacturing activities as described in the North American Industrial Classification System (NAICS) codes 325411, 325412, 325413, 325414, 334510, and 541711, including medicinal and botanical, pharmaceutical preparation, in-vitro diagnostic substance or biological product manufacturing. Biotechnology manufacturing would also include research and development in biotechnology.

The bill also defines the terms “manufacturing,” “primarily,” and “process” and the tangible personal property intended to be included or excluded from the proposed full exemption are described.

The bill would specify that the proposed exemption would *not* include (1) any tangible personal property that is used primarily in administration, general management, or marketing, (2) consumables with a normal useful life of less than one year, except for fuels consumed or used in the manufacturing process, and (3) furniture, inventory, equipment used in the extraction process, or equipment used to store finished products that have completed the manufacturing process.

On or after January 1, 2020, the bill requires the LAO to report to the Joint Legislative Budget Committee on the effectiveness of this tax exemption by evaluating various factors, including, but not limited to, all of the following:

- 1) Amount of tax revenue lost to the state as a result of this tax exemption.
- 2) Number of employers claiming the tax exemption and the nature of the claims, such as the size of the employer, the location of the employer, and the primary biotechnology emphasis of the employer.
- 3) Activities and products for which this tax exemption was claimed.
- 4) Number of jobs created in California as a result of this tax exemption.

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- 5) Number of businesses that have remained in California or relocated to California as a result of this tax exemption.

As a tax levy, the bill would become effective immediately, but would become operative on January 1, 2012. The bill's provisions would remain in effect until January 1, 2020, and as of that date are repealed.

### BACKGROUND

For a ten-year period ending December 31, 2003, the law provided a partial (General Fund only) sales and use tax exemption for purchases of equipment and machinery by new manufacturers, and income and corporation tax credits for existing manufacturers' investments (MIC) in equipment. Manufacturers were defined in terms of specific federal "Standard Industrial Classification" (SIC) codes. The exemption provided a state tax portion for sales and purchases of qualifying property, and the income tax credit was equal to six percent of the amount paid for qualified property placed in service in California. Qualified property was similar to the property described in this bill – depreciable equipment used primarily for manufacturing, refining, processing, fabricating or recycling; for research and development; for maintenance, repair, measurement or testing of qualified property; and for pollution control meeting state or federal standards. Qualified property also included tangible personal property purchased by a contractor, as specified, for use in the performance of a construction contract for the qualified person who would use that property as an integral part of the manufacturing process, as described. Certain special purpose buildings were included as "qualified property," as this bill proposes. New manufacturers could either receive the benefit of the exemption, or claim the income tax credit. However, existing manufacturers could only receive the benefit of the income tax credit.

This sales and use tax exemption and income tax credit had a conditional sunset date. They were to sunset in any year following a year when manufacturing employment (as determined by the Employment Development Department) did not exceed January 1, 1994 manufacturing employment by more than 100,000. On January 1, 2003, manufacturing employment (less aerospace) did not exceed the 1994 employment number by more than 100,000 (it was less than the 1994 number by over 10,000), and therefore the MIC and partial sales tax exemption sunsetted at the end of 2003.

**Legislative History.** Since the expiration of the partial exemption of manufacturing equipment, numerous bills have been introduced either to reinstate or to expand or modify the exemption, but failed to pass. A sample of bills introduced during the last three Legislative Sessions includes the following:

Bill No.	Session	Author	Proposed Exemption
AB 810 and AB 829	2009-10	Caballero	Qualifying tangible personal property, including sustainable development equipment investments, by persons engaged in manufacturing, research and development, and software publishing
AB 1719	2009-10	Harkey	Reinstate the original exemption for qualifying tangible personal property by new trades or businesses engaged in manufacturing
AB 1812	2009-10	Silva	Qualified tangible personal property by persons engaged in manufacturing and software production
AB 2280	2009-10	Miller	Equipment by manufacturers engaged in manufacturing activities

SB 1053	2009-10	Runner	Qualifying tangible personal property by persons engaged in manufacturing and software publishing and their affiliates
SBx6 18	2009-10	Steinberg & Alquist	Qualifying tangible personal property by persons engaged in specific manufacturing and software production activities
SBx6 8 and SBx6 44	2009-10	Dutton	Qualifying tangible personal property by manufacturers and software publishers and affiliates engaged in manufacturing activities or research and development
AB 1152	2007-08	Niello	Qualifying tangible personal property by persons engaged in manufacturing and software production
AB 1206	2007-08	Smyth	Machinery and equipment used in research and development activities
AB 1681	2007-08	Houston	Qualified tangible personal property for use by qualified persons engaged in manufacturing, telecommunications, and electrical generation activities
AB 344	2005-06	Villines	Qualifying tangible personal property by qualified persons primarily engaged in manufacturing, telecommunications and electrical generation activities. Would apply to 25% of the sales or purchases for 2006, 50% for 2007, and 100% thereafter.
AB 1580	2005-06	Torrico	Qualifying tangible personal property by qualified persons primarily engaged manufacturing, construction contracting, software production, telecommunications, cable distribution, scientific research and development services, and wholesale distribution of recyclable materials
SB 552	2005-06	Alquist	Materials, supplies, machinery and equipment used by entities engaged in manufacturing, research and development, telecommunications, software production, and printing, and for semiconductor, biotechnology and pharmaceuticals clean rooms and equipment. Includes optional Bradley-Burns local and district tax exemption
SB 1291	2005-06	Alquist	Materials, supplies, machinery and equipment used by entities engaged in manufacturing, research and development, software production, and newspaper printing, and for semiconductor, biotechnology and pharmaceutical clean rooms and equipment

## COMMENTS

1. **Sponsor and Purpose.** The author is sponsoring this bill in an effort to create jobs and encourage investment in the biotechnology-manufacturing sector. According to the author's office, "Biotechnology is the application of genetic and cellular research to develop and manufacture pharmaceutical and therapeutic products; and diagnostic and medical devices. A major hurdle for biotechnology manufacturers is the cost of the necessary equipment needed to create their products. California, Rhode Island and Arkansas are the only states that tax the sale of manufacturing equipment. This is a strong disincentive for manufacturers searching for the right place to invest, build, and hire."

In addition, a report prepared by the Milken Institute in June 2002, *Economic Impact Of A Sales Tax Reduction On Manufacturing Equipment*, examined the impact of a sales tax reduction of 5 percent on the purchases of manufacturing and telecommunications equipment. <http://www.milkeninstitute.org/pdf/CMTA-Rev.pdf>. The findings indicated that enacting a 5 percent sales tax reduction would lead to higher capital formation, promote greater job and income growth, and after an initial loss, ultimately increase tax receipts in California.

2. **The May 17, 2011 amendments** (1) clarify that a qualified person does not include a person engaged in specified research and development and marketing research activities, (2) add a sunset date, and (3) require the LAO to report to the Joint Legislative Budget Committee on the effectiveness of this tax exemption.
3. **What types of entities do Codes 325411, 325412, 325413, 325414, 334510, and 541711 include?** These codes include establishments primarily engaged in specified manufacturing and research and development activities.

Codes 325411, 325412, 325413, 325414, and 334510 represent establishments primarily engaged in manufacturing activities. These activities include manufacturing of uncompounded medicinal chemicals (i.e., generally for use by pharmaceutical manufacturers) and/or processing (i.e., grading, grinding, and milling) of uncompounded botanical drugs and herbs. They also include manufacturing of in-vivo diagnostic substances pharmaceutical preparations intended for internal and external consumption in dose forms such as tablets, capsules, ointments, powders, and solutions and manufacturing of in-vitro diagnostic substances, such as chemical, biological, or radioactive substances. These substances are used for diagnostic tests that are performed in test tubes, petri dishes, machines, and other diagnostic test-type devices. The specified manufacturing activities also include manufacturing electromedical and electrotherapeutic apparatus, such as magnetic resonance imaging equipment, medical ultrasound equipment, pacemakers, hearing aids, and electrocardiographs.

Code 541711 is comprised of establishments primarily engaged in conducting biotechnology research and experimental development. Biotechnology research and experimental development involves the study of the use of microorganisms and cellular and biomolecular processes to develop or alter living or non-living materials. This biotechnology research and development may result in development of new biotechnology processes or in prototypes of new or genetically-altered products that may be reproduced or utilized by various industries.

#### 4. **Administrative and technical concerns:**

- This bill defines a “qualified person” as a person engaged in biotechnology manufacturing, which this bill defines as manufacturing in the lines of business described in specifically identified NAICS codes. As stated above under “Background,” the BOE administered the former sales and use tax exemption (Section 6377) for manufacturing equipment for a 10-year period. The former statute defined a qualified person as a person whose business falls within specified NAICS codes. In order to administer the proposed exemption similarly to the former manufacturing exemption, we recommend placing the specified NAICS codes under the definition of a “qualified person.”

- In defining “qualified person,” it is recommended that the bill require that the qualifying person be *primarily* engaged in the activities described in the referenced codes. This is an important issue and one that generated many disputes when the BOE administered the sales and use tax manufacturing equipment exemption previously.
  - Another issue relates to the proposed definitions for the types of property included and excluded from the proposed exemption. For example, on page 3, lines 27 and 37, the bill refers to the items having a *useful life* of one year or more (or less than one year). In order to lessen potential audit disputes, the bill should contain some mechanism for determining the useful life. Perhaps some reference to the provision in the California income tax laws for depreciating assets should be incorporated into the bill.
  - Subdivision (c) would require a purchaser to furnish an exemption certificate to the retailer and the retailer to subsequently furnish the BOE with a copy of the exemption certificate (this provision was in the former Section 6377). This provision will require the BOE to store copies of each exemption certificate taken by a retailer, which is a cumbersome process for BOE staff. To address this concern, staff suggests that the bill be amended to require the retailer to retain a copy of each exemption certificate and make it available to the BOE for examination upon request. Staff will assist the author’s office in drafting this proposed amendment.
- 5. Purchases of some equipment would be fully exempt from the sales tax.** This bill would provide a full sales and use tax exemption for sales and purchases of equipment purchased by a manufacturer or entity conducting specified research and development for use in its manufacturing and research and development business. These entities who qualify for the proposed exemption would not be required to pay the full statewide sales and use tax rate of 7.25 percent, plus any applicable district taxes on their purchases of equipment.
- 6. The term “property” needs clarifying.** The term “property,” which is used throughout proposed Section 6377.1, needs clarifying. As currently drafted, the bill would exempt sales of tangible personal property purchased by a qualified person for use in the manufacturing of “property.” Traditionally, when the Legislature addresses the manufacturing of property, it means the traditional manufacturing of tangible personal property, not the creation of intangibles or the provision of services and utilities. To the extent that the bill does not expressly limit such term to the manufacturing of tangible personal property, then it may be asserted that it has left open the door to unintended arguments that it includes the creation of intangible property or the provision of services and utilities. To avoid any unintended consequences in administering the proposed exemption, the term “property” should be replaced with “tangible personal property.”
- Without this clarification, the bill would not only complicate administration of the statute, but also would potentially open the door for aggressive litigation from the providers of services, utilities, and intangibles, possibly resulting in significant revenue losses to the state far beyond what the Legislature intended. While arguments for such greater scope seem unreasonable and overbroad, clarification now would help preclude unanticipated future issues and problems.

**7. Related legislation.** Similar bills have been introduced this year:

- SB 47 (Alquist) would provide a partial (General Fund and Fiscal Recovery Fund) sales and use tax exemption for purchases of qualifying tangible personal property used by entities engaged in manufacturing, research and development, newspaper printing, and software production, and for semiconductor, biotechnology and pharmaceutical clean rooms and equipment.
- SB 395 (Dutton) would provide a partial (General Fund only) sales and use tax exemption, beginning January 1, 2012 and before January 1, 2019, on tangible personal property purchased for use in manufacturing activities by manufacturers and software publishers and affiliates.
- AB 204 (Halderman) would provide a partial (General Fund and Fiscal Recovery Fund) sales and use tax exemption for purchases of equipment by a biomass energy facility, as defined, for use in its biomass energy production activities.
- AB 218 (Wieckowski), among its provisions, would provide a partial (General Fund only) sales and use tax exemption for purchases of certain tangible personal property by qualified persons engaged in manufacturing and software production, as specified and defined. This bill would intend to use revenue generated from the estate tax, which this bill would create, to supplant the reduction of General Fund revenue as a result of the exemption. Its enactment, however, would require voter approval at the next statewide General Election.
- AB 303 (Knight) would reinstate the partial (General Fund only) sales and use tax exemption for purchases of qualifying tangible personal property by new trades or businesses engaged in manufacturing.
- AB 979 (Silva) would provide a partial (General Fund only) sales and use tax exemption, beginning January 1, 2012, on tangible personal property purchased for use in manufacturing activities and software production by manufacturers and affiliates.
- AB 1057 (Olsen) would provide a partial (General Fund only) sales and use tax exemption, beginning January 1, 2014 and before January 1, 2020, on tangible personal property purchased for use in manufacturing activities, research and development, and air pollution mitigation by manufacturers and affiliates.

**COST ESTIMATE**

The BOE would incur administrative costs attributable to programming, return revisions, and return processing. In addition, the BOE would incur costs to identify and notify qualifying entities, prepare a special publication and exemption certificate, audit claimed exemptions, and answer inquiries from the public and taxpayers. An estimate of these costs is pending.

**REVENUE ESTIMATE****BACKGROUND, METHODOLOGY, AND ASSUMPTIONS**

This revenue estimate is based on the specific NAICS codes identified in the bill. The following is a breakdown of the codes:

325411 – Medicinal and botanical manufacturing  
 325412 – Pharmaceutical preparation manufacturing  
 325413 – In-vitro diagnostic substance manufacturing  
 325414 – Biological product (except diagnostic) manufacturing  
 334510 – Electromedical and electrotherapeutic apparatus manufacturing

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## 541711 – Research and development in biotechnology

In utilizing U.S. Census Bureau tools that include the *Annual Survey of Manufactures* (ASM), *Annual Capital Expenditures Survey* (ACES) and the *Economic Census*, capital expenditures (machine and equipment and fuels) was estimated for the above NAICS codes. In FY 2008-09 (most recent data available), capital expenditures amounted to an estimated \$1,379 million. Given that this bill would become operative on or after January 1, 2012, we used the most recent forecast of business equipment investment of IHS Global Insight, a national economic forecasting firm, we estimate expenditures as follows:

<b>California Expenditures</b>				
(in millions)				
NAICS Code	FY 2008-09	FY 2011-12	FY 2012-13	FY 2013-14
3254	\$848	\$1,095	\$1,170	\$1,240
334510	166	214	229	242
541711	286	370	395	419
Total	\$1,300	\$1,679	\$1,794	\$1,901

It should be noted that NAICS code 3254 (Pharmaceutical and Manufacturing) is a total of codes 325411, 325412, 325413, 325414.

**REVENUE SUMMARY**

The revenue impact from exempting tangible personal property purchased by a qualified person for use primarily in the biotechnology manufacturing process from sales and use tax (7.25%, plus applicable district taxes) amounts to:

<u>Estimated Sales and Use Tax Loss</u>			
(In Millions)			
	FY 2011-12 <sup>1</sup>	FY 2012-13	FY 2013-14
State (5.0%)	\$42	\$90	\$95
Fiscal Recovery Fund (0.25%)	2	4	5
Local Revenue Fund (0.5%)	4	9	10
Local Public Safety Fund (0.5%)	4	9	10
Bradley Burns (1.0%)	8	18	19
Special District (0.86%)	7	15	16
Total Revenue Loss	\$67	\$145	\$155

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Is			0686sb051711dw.doc

<sup>1</sup> Given that this bill is operative on or after January 1, 2012, the estimated \$72 million in sales and use tax loss reflects six months of FY 2011-12.

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